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No. 02-1355

In the Supreme Court of the United States

WILLIAM BARSTOW, III, PETITIONER

v.

INTERNAL REVENUE SERVICE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether 11 U.S.C. 724(b), which allows property subject to a tax lien to be distributed first to priority creditors, applies to property encumbered by a lien that attached pursuant to a judicially-sanctioned agreement that allowed the property to be used in the debtor's reorganization.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-20a) is reported at 308 F.3d 1038. The opinion of the district court (Pet. App. 21a-37a) is reported at 272 B.R. 710. The opinion of the bankruptcy court (Pet. App. 38a-39a) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on October 21, 2002. A petition for rehearing was denied on December 13, 2002. Pet. App. 42a-43a. The petition for a writ of certiorari was filed on March 12, 2003. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In June 1992, MarkAir, Inc., filed a petition for reorganization under Chapter 11 of the Bankruptcy Code. Pet. App. 2a. When it filed the reorganization petition, MarkAir was liable for a substantial amount of unpaid federal excise taxes. *Ibid.* After the bankruptcy case was commenced, however, MarkAir applied for a refund of approximately $3.1 million of other taxes that it claimed to have overpaid. *Id.* at 3a. The company petitioned the bankruptcy court for authority to use that refund to secure obligations it owed to Airline Reporting Corporation (ARC), a ticket clearinghouse whose services were essential to MarkAir's continued operations. ARC had threatened to stop providing services to MarkAir unless the company posted a letter of credit in the amount of $1.8 million. *Ibid.*

To facilitate the continuing operation of MarkAir, an agreement was entered into by ARC, MarkAir, MarkAir's parent corporation (Alaska International Industries, Inc. (AII)), and the Internal Revenue Service concerning the refund claimed by MarkAir. Pet. App. 3a. Pursuant to that agreement, (i) the IRS agreed to forego its right to offset the $3.1 million refund against other taxes owed by MarkAir and (ii) MarkAir agreed to release $1.8 million of the refund to the bankruptcy court to serve as collateral to secure ARC's continued performance while (iii) MarkAir further agreed that $1.3 million of the claimed refund would be retained by the IRS and that any portion of the $1.8 million used as collateral would be returned to the IRS upon termination of the interim operating agreement with ARC. *Ibid.*

Under the terms of this agreement, ARC was granted a "first judicial lien" and the IRS was granted a

"second place judicial lien" in the $1.8 million collateral amount. Pet. App. 3a. The bankruptcy court issued an order approving the agreement. *Ibid.*

2. MarkAir failed to complete its confirmed plan of reorganization and subsequently filed a second Chapter 11 petition, which was thereafter converted to a Chapter 7 liquidation. Pet. App. 4a. ARC's claims were paid off shortly after the conversion to the Chapter 7 proceeding. *Ibid.* The IRS then applied to recover the $1.8 million collateral deposit pursuant to the terms of the collateral agreement. *Ibid.*

Petitioner, who is the trustee in MarkAir's liquidation proceeding, opposed the government's motion. Petitioner claimed that the judicial lien obtained by the IRS through the consent of the parties should be subordinated to the claims of other creditors under 11 U.S.C. 724(b). That statute allows property "subject to a lien * * * that secures an allowed claim for a tax" to be used to pay other creditors in specified situations. See 11 U.S.C. 724(b)(1)-(6).

The bankruptcy court rejected petitioner's claim. Pet. App. 38a-39a. The court explained that the text of this statute makes clear that Section 724(b) applies only to statutorily-created "tax liens" and does not apply to judicial liens that are created under collateral agreements authorized by the court to facilitate continued operations of the debtor. *Id.* at 39a.

3. The district court affirmed. Pet. App. 21a-37a. The court noted that Section 724(b) expressly applies to a "tax lien," which is a term generally understood to refer to a lien created by statute that arises automatically upon the nonpayment of taxes. *Id.* at 31a-34a. Looking at the language of Section 724 "as whole," the court concluded that "the lien described in § 724(b) is a statutory tax lien." Pet. App. 33a. The court pointed

out that the legislative history of the statute also "makes it evident that 11 U.S.C. § 724(b) specifically applies to statutory tax liens." Pet. App. 37a.

4. The court of appeals affirmed. Pet. App. 1a-20a. The court concluded that Section 724(b) provides for subordination of tax liens created by statute and does not apply to consensual liens approved by the bankruptcy court in the circumstances of this case. In reaching that conclusion, the court noted that the statutory phrase "lien that secures an allowed claim for [a] tax" could be read to apply "to any kind of lien that secures an allowed claim for [a] tax," whether a statutory or judicial or consensual lien. Pet. App. 7a. The court pointed out, however, that the statute also expressly refers to "tax liens," which is a "term [that] does, in general, refer to statutory tax liens." *Id.* at 8a. The court stated that "Congress' frequent use of the term 'tax lien' in § 724(b) interjects ambiguity" in the statute. Pet. App. 7a.

The court then reviewed the legislative history of Section 724(b) and agreed with the district court that it "supports the IRS's interpretation of the statute." Pet. App. 12a. The court noted that Section 724(b) is a successor to Section 67c of the Chandler Act, which had subordinated only statutory tax liens on personal property and had no effect on judicial liens or contractual liens. Pet. App. 12a-14a. The court explained that the legislative history of Section 724(b) establishes that the new statute was "derived" from Section 67c(3) "without substantial modification in result." Pet. App. 14a (quoting H.R. Rep. No. 595, 95th Cong., 1st Sess. 382 (1977)).

The court also concluded that the government's interpretation of Section 724(b) was "more consonant with the overall bankruptcy scheme." Pet. App. 18a. Under

petitioner's reading of the statute, the refund provided by the IRS became subject to Section 724(b) only when it was paid into court and became subject to the consensually-created judicial lien. Pet. App. 19a. Petitioner's interpretation of Section 724(b) would "discourage taxing authorities from releasing any funds that otherwise could be used to resurrect a failing company" and would thereby impede an essential goal of the bankruptcy process. *Ibid.*

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Moreover, the question addressed in this case—whether a judicial lien constitutes a "tax lien" within the meaning of Section 724(b) of the Bankruptcy Code—has not been addressed by any other appellate court. Further review is therefore not warranted.

1. In the liquidation of a Chapter 7 estate, Section 724(b) of the Bankruptcy Code subordinates a "tax lien" to the claims of other creditors holding priority claims. 11 U.S.C. 724(b). The subordination of tax liens to priority claimants has long been part of the distribution scheme in liquidation cases under the federal bankruptcy laws. The rule first appeared in Section 67c of the Chandler Act, ch. 575, 52 Stat. 877. Section 67c specified that "statutory liens, including liens for taxes," in personal property were subordinated to the claims of priority claimants. See *Goggin* v. *Division of Labor Law Enforcement of California*, 336 U.S. 118, 119 n.1 (1949). Section 67c was revised in 1966 (and renumbered as Section 67c(3)) specifically to authorize subordination of a "tax lien on personal property not accompanied by possession." Pub. L. No. 89-495, 80

Stat. 269. In making that revision, Congress expressly noted that the term "tax lien" refers only to *statutory* tax liens. S. Rep. No. 1159, 89th Cong., 2d Sess. 6, 8 (1966) ("new section 67c establishes more effective standards for the treatment of statutory liens"). These 1966 revisions made clear that the subordination authorized by the statute was "limited to statutory liens and does not include consensual liens." *Id.* at 6.

When Congress again revised the bankruptcy laws in 1978, the rule of Section 67c(3) was recodified as Section 724(b) of the Bankruptcy Code. Unlike its predecessor, the new Section 724(b) authorizes subordination of tax liens in real, as well as personal, property. No other change was made to the statute. As the 1978 legislative history emphasizes, Section 724(b) was "derived from section 67(c)(3) of the Bankruptcy Act, without substantial modification in result." H.R. Rep. No. 595, 95th Cong., 1st Sess. 382 (1977).

In similar contexts, courts have properly been "reluctant to accept arguments that would interpret the [Bankruptcy] Code * * * to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history." *Dewsnup* v. *Timm*, 502 U.S. 410, 419 (1992). If Congress had intended to broaden the term "tax lien" to include nonstatutory judicial liens and contractual liens, it presumably would have said so. See *Pennsylvania Dep't of Public Welfare* v. *Davenport*, 495 U.S. 552, 563 (1990) ("[w]e will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure").

Petitioner nonetheless contends that, in enacting Section 724(b) in 1978, Congress intended to broaden the term "tax lien" by referring, in the opening phrase of Section 724(b), to a "lien * * * that secures an

allowed claim for a tax." 11 U.S.C. 724(b). Nothing in that language, however, provides support for a claim that Congress intended to overhaul the accepted understanding on which the statute was enacted—that the "tax lien" that is subordinated to the claims of priority creditors is a statutory lien and not one created by consent or court order. As the court of appeals correctly recognized (Pet. App. 7a), the term "tax lien" appears seven times in Section 724(b) and that term plainly refers to the lien for taxes that is imposed by statute and that arises by operation of law in "all property and rights to property" of the taxpayer whenever taxes are not timely paid (26 U.S.C. 6321).[1] Other courts have consistently reached this same conclusion in related contexts under the bankruptcy laws, in holding that the term "tax lien" refers only to a statutory lien for taxes that arises by operation of law when the tax liability goes unpaid. *In re Khoe*, 255 B.R. 581, 588 (Bankr. E.D. Cal. 2000); *Filipovits* v. *IRS*, 76 A.F.T.R.2d (RIA) ¶ 95-5501 (Bankr. D. Md. 1995); *In re Wiles*, 173 B.R. 92 (Bankr. M.D. Pa. 1994); *In re*

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[1] Petitioner errs in contending that the court's reading of Section 724(b) improperly ignores the fact that the term "tax lien" is invariably preceded in the statute by the modifier "such." Petitioner claims (Pet. 14) that the court failed to recognize that the word "such" ties the term "tax lien" to the preceding phrase "lien * * * that secures an allowed claim for a tax," thus making the two phrases mean the same thing. The court of appeals did not ignore the word "such" in Section 724(b). Instead, the court correctly concluded that the word "will not bear so much weight" as petitioner would assign to it. Pet. App. 11a. As discussed in the text above, there is no indication that Congress intended the phrase "lien * * * that secures an allowed claim for a tax" to mean anything different than a "tax lien."

Carolina Resort Motels, Inc., 51 B.R. 447, 450 (Bankr. D.S.C. 1985).[2]

The decision of the court of appeals is consistent with the accepted understanding of the term "tax lien" and with the manner in which that term has been applied in the bankruptcy laws. Neither the text of the statute nor the legislative history indicates that Congress intended to adopt some different understanding of the term "tax lien" in Section 724(b).

2. Petitioner errs in asserting (Pet. 20) that a conflict exists between the decision in this case and the decision in *In re K.C. Machine & Tool Co.*, 816 F.2d 238 (6th Cir. 1987). The question addressed in *K.C. Machine* is unrelated to the one presented here. In *K.C. Machine*, property in a bankruptcy estate was subject to both a private security interest and a municipal tax lien. The municipal lienholder argued that the property should be abandoned to the creditors under 11 U.S.C. 554(b) because it was fully encumbered and thus had inconsequential value to the estate.[3] The trustee, however, argued that the property remained beneficial to the estate because, if it were sold by the estate, the proceeds of the sale would be distributed under Section 724(b) and thereby provide administrative claimants

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[2] Section 724(d) of the Bankruptcy Code provides additional support for this conclusion. That Section specifies that "[a] statutory lien the priority of which is determined in the same manner as the priority of a tax lien under section 6323 of the Internal Revenue Code of 1986 shall be treated under subsection (b) of this section the same as if such lien were a tax lien." 11 U.S.C. 724(d).

[3] Section 554(b) of the Bankruptcy Code provides that "[o]n request of a party in interest and after notice and a hearing, the court may order the trustee to abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate." 11 U.S.C. 554(b).

with a means of recovery on their claims. The Sixth Circuit agreed with the trustee that subordination of a tax lien to the claims of administrative claimants under Section 724(b) would confer a benefit on the estate and that the bankruptcy court had thus erred in ordering the property to be abandoned. 816 F.2d at 247. That holding does not conflict in any manner with the decision in this case.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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